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SUBJECT: BRAZIL'S FISCAL GORDIAN KNOT

REF: A) BRASILIA 0790 B) BRASILIA 1151

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¶1. (SBU) Summary: Fresh from its reelection victory, the Lula Administration has begun to consider the elements of a plan to try to cut through its fiscal Gordian knot: a rigid budgetary system rife with constitutional earmarks and revenue sharing requirements, a large debt service burden, high and complex taxes, a burgeoning social security deficit, galloping current expenditures growth and tax cut one-upmanship among the states. Dealing with the fiscal Gordian knot is a sine qua non for reducing the GoB's high borrowing requirement, which crowds out private investment and increases prevailing interest rates, thus dampening the level of sustainable growth. The end-2007 expiration of a temporary measure de-earmarking 20% of federal revenues from the constitutional revenue-sharing and earmarking provisions (known as the DRU), without which the federal government would be unable to meet all of its spending obligations, requires that the GoB address many of these fiscal issues within the next year. Moreover, business and the middle class are clamoring for reductions in the tax burden, which exceeds 38% of GDP, and increases in public investment. There nevertheless appears to be a lack of ambition in the measures recently mooted by the finance ministry. While details are sketchy, in its broad outlines the Finance Ministry is proposing: a) some reform of the social security system; b) to extend and perhaps expand the DRU de-earmarking provisions; c) to extend but reduce the CPMF financial transactions tax; d) to make unspecified cuts in current expenditures and improve tax collection; e) to provide for Reais 15 Billion (USD 7.1 billion) in low income housing subsidies drawn from a payroll-tax financed fund; and f) to reduce taxes by Reais 12 billion/year (USD 5.7 billion) for certain targeted sectors, including construction, capital investment, and infrastructure investment funds. Most of these ideas must still be

vetted within the Administration. End summary.

The Fiscal Gordian Knot

¶2. (U) Brazil has a high tax burden for a developing country, over 38% of GDP at the federal, state and municipal level. Moreover, the tax system's complexity makes compliance onerous and reduces the efficiency of the economy. Up to 1994, use of the "inflation tax" meant Brazil did not face a hard budget constraint; many debts could be inflated away. Tax collection in 1994 amounted to about 26% of GDP. Former President Cardoso's 1994 inflation-killing Real Plan made the budget constraint a real one, but the rigidities of the 1988 constitution, which earmarks revenues for certain uses and requires the federal government to share tax revenue with states and municipalities, made it difficult to cut federal expenditures. Debt levels began to increase sharply as governments (especially states and municipalities) borrowed heavily, often from state-owned banks, to meet spending demands. This led to a debt payments crisis at the sub-national level in 1998/99.

¶3. (U) To resolve the debt crisis the federal government assumed the state/municipal debt but put the states and municipalities on a very short fiscal leash, the terms of which were enshrined in the Fiscal Responsibility Law (LRF), which sets limits on state indebtedness, payroll expenditures, etc. and requires state/municipal payments to the federal government for the debt it assumed on their behalf. The state-owned banks were, for the most part, privatized or liquidated. The cleanup of state-level finances was expensive for the federal government. Its gross public sector debt grew from 42.4% of GDP in 1997 to an estimated 72.1% in 2006. Currently the great majority of this debt is financed domestically and is of short tenor. Although

improving, currently the average maturity of the GoB's domestic bonds is about 30 months and about 37.8% of this debt matures within the next twelve months. Refinancing these bonds sucks up significant amounts of domestic capital and crowds out private investment. It also is one the primary reasons that Brazil has high real interest rates, currently about 9.6% (based on expected inflation over the next year).

¶4. (U) Meanwhile, in order to meet burgeoning federal debt service obligations and other spending demands, the federal government introduced in 1998/1999 the DRU to exempt 20% of revenues from earmarks and revenue sharing, as well as a series of new taxes (which it labeled "contributions" in order to avoid the constitutional requirement that tax revenue be shared with the states) over the same period. These contributions helped raise the tax burden by almost 12% of GDP over the last decade to about 38% today. Although these new taxes were effective in raising federal income, they were implemented on a somewhat ad hoc basis, with more consideration given to enforceability and revenue generating potential than to the complexity and economic inefficiencies they would create. Thus Brazil taxes production very heavily - frequently at the source -and taxes (almost) any bank transaction, because such levies are easy to enforce.

¶5. (U) Shortly after taking office, the Lula Administration undertook partial tax reform to make two social "contributions" assessed on company revenues (the PIS and COFINS) more VAT-like and remove their cascading application. It increased the rates for both in order to compensate for the reduced tax base. Due to political considerations, however, it was forced to abandon an effort to reform the state-level VAT system (ICMS), one of the main sources of complexity in the system due to the differing legislation and rates from state to state. It also has introduced as series of targeted tax breaks, for example exempting certain exporters' purchases of capital investments from taxation. Another change reduced taxation for long term investments in bonds, including government paper. Other measures benefited the construction and real estate sectors.

What is Being Proposed?

¶6. (SBU) Although there is consensus in most policy circles that Brazil needs fiscal reform, including mention in the OECD's most recent report on Brazil, the end-2007 expiration of the DRU (and the financial transactions tax CPMF) will bring the issue to sharper political focus. This may prove a useful excuse for the GoB to seek to undo some of the budgetary rigidities created by the 1988 constitution. Its earmarking provisions and revenue sharing formulas, coupled with debt service and the wage and pension bill (i.e. covering the social security system deficit) means that over 90% of federal expenditures are non-discretionary. Allowing the DRU to expire would push this percentage close to 100%, an untenable situation for the GoB. At a minimum the Lula Administration will have to seek to renew the 20% exemption contained in the DRU. Some commentators have suggested it will push for an expansion to 35% but ultimately will have to settle for renewal at the 20% level and will pay a high political cost to woo sufficient congressional votes to do so. Expansion of the DRU at a higher level, however unlikely, would allow greater flexibility for re-directing spending to priorities such as public investment to alleviate infrastructure bottlenecks.

¶7. (SBU) The burgeoning social security deficit also is a strong candidate for the most urgent reform for 2007. The deficit in the private sector social security system (INSS) has doubled from 1% to 2% of GDP and from 6% to 12% of federal expenditures over the last

four years. Left unchecked, it will absorb increasing portions of the federal budget (ref B). Press reporting indicates that the GoB is considering a package of management reform measures and the introduction of a minimum retirement age (currently men who have contributed to the system for 35 years and women who have done so for 30 years can retire without regard to their age). The GoB has discussed grandfathering under existing rules those who already have met the minimum service requirements but have not yet retired. While these are useful initiatives, they leave untouched what most experts have told us is the biggest problem, which is the link between the minimum wage and minimum pension level. De-linking the two, however, would require a constitutional amendment.

TABLE - INSS DEFICIT
(Percent of GDP)

	2002	2003	2004	2005	2006 /1
INSS Revenues (payroll tax)	5.3%	5.2%	5.3%	5.6%	5.6%
INSS Expenditures	6.4%	6.9%	7.1%	7.58%	7.93%
INSS Deficit	1.1%	1.7%	1.8%	1.98%	2.33%
INSS Deficit as percent of federal expenditures	6.1%	9.8%	10.1%	10.3%	12.7%

/1 - Predicted 2006 values
-Data Source: Planning Ministry

¶8. (SBU) Beyond the financial burden it imposes, Brazil's tax system is poorly structured, exacerbating the economic inefficiencies it creates. There is also some movement to address tax reform, which was one of the seven policy principles that Lula and the centrist PMDB party announced November 22 would be the basis for negotiating a congressional coalition. The document calls for tax reform with a reduction in the tax burden and incentives for investment, and the implementation of selective tax cuts. Many analysts believe that the state-level ICMS value added tax system, which is governed by 27 different pieces of legislation across states with widely varying tax rates on similar items, needs reform the most. It is unclear that the GoB will have the political wherewithal to tackle this

complex reform after attempts to do so in 2004 and 2005 were derailed by state governors unwilling to accept potential revenue losses. Some elements within the GoB have, nevertheless, proposed facilitating ICMS reform by creating a federal government fund to aid the poorer states during the transition to a new system.

¶9. (SBU) Continuing his enthusiasm for targeted tax relief for favored sectors, Finance Minister Mantega on November 23 announced a set of measures, many of the details of which are still uncertain, that would extend Reais 12 billion (USD 5.7 billion) in tax breaks to some sectors. Mantega stated that the GoB would exempt infrastructure funds (private investment funds to be created to invest specifically in infrastructure projects) from income taxes. In addition, construction materials would be exempted from the federal VAT on industrial products (known as the IPI). Investment in certain capital equipment also would benefit from an immediate exemption from the IPI tax and a delayed credit on PIS and COFINS taxes.

¶10. (SBU) Current expenditures have been rising faster than GDP growth over the past two years, in part the product of the Lula Administration's 12% real increase in the minimum wage since 2004. While the Lula Administration has never missed a primary budget surplus target and is unlikely to do so, the growth in current expenditures has reduced the GoB's ability to invest in infrastructure. Aside from bromides about good management, the GoB has said very little about how it plans to contain expenses. Nevertheless, limiting the growth of expenditures to less than the growth of GDP was one of the seven policy points agreed on between Lula and PMDB as the basis for negotiations for forming their congressional coalition.

¶11. (SBU) The Finance Ministry also has proposed creating space for greater infrastructure investment by expanding the size of its pilot investment program (PPI), under which certain infrastructure investments are not counted against its primary surplus target (i.e. effectively reducing the primary surplus target by this amount). Under the plan, the PPI would increase from Reais 4.6 billion (USD 2.1 billion or 0.2% of GDP) to Reais 10.6 billion (USD 5 billion or 0.5% of GDP) and the implied primary surplus target would fall to 3.75% of GDP from today's target of 4.25% of GDP (or 4.05% of GDP with the current level of investments under the PPI included). However, while the GoB has included the PPI in recent budgets, it has yet to use this flexibility to drop below the primary surplus target of 4.25% of GDP -- the primary surplus result was 4.6% of GDP in 2004, 4.8% of GDP in 2005 and is expected to be about 4.4% of GDP in 2006.

¶12. (SBU) Comment: There's much ferment in Brasilia policy circles over fiscal issues right now as the Lula Administration considers its strategy for dealing with one of its biggest challenges for ¶2007. Although the election has increased Lula's political capital and the expected formalization of a coalition with the PMDB may help Lula get some proposals through Congress, we expect modest results on the big issues, such as social security reform, expansion of the DRU de-earmarking measure and reform of the state-level value added tax. On these issues, entrenched interests and/or the need to obtain Congressional supermajorities to amend the constitution will facilitate the work of those seeking lowest-common denominator outcomes. Whether the measures ultimately passed have a big enough impact to lower the GoB borrowing requirement and redirect capital in the economy to the private investment necessary to raise sustainable growth levels remains an open question. End Comment.

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